

EX PARTE OR LATE FILED



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October 24, 1996

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
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Washington, D.C. 20554

Re: CC Docket Number 96-45

Dear Mr. Caton:

Please find enclosed an original and one copy of the Ex Parte Presentation of the State of Maine Public Utilities Commission, Vermont Department of Public Service, Vermont Public Service Board, and West Virginia Public Service Commission in the above docket. Copies of this presentation have been mailed to all parties listed in the Commission's service list, released July 3, 1996, attached to the Common Carrier Bureau's Request for Further Comment in this docket.

I also enclose one additional copy, marked "STAMP COPY." Please date stamp this copy and return it to me in the enclosed postage-paid envelope.

Sincerely,

A handwritten signature in cursive script, appearing to read "Peter Bluhm".

Peter M. Bluhm
Policy Director

Enclosure (postage-paid envelope)

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(Two copies of this presentation have been filed with the Secretary of the Commission as required by section 1.1206(a)(1) of the Commission's Rules.)

SUMMARY

Rural areas have a great deal to lose if the Joint Board and the Commission should fail to design a suitable mechanism for distributing universal service support or should fail to adequately fund whatever mechanism they develop. The rural states participating in this filing are concerned that the Joint Board and the Commission may be considering a "bifurcated" approach for universal service support based upon company size. We file this presentation because of the critical nature of this issue to the many rural states.

The Joint Board and the Commission should ensure that the new universal service mechanism is cost-based. In particular, this means that the Joint Board and the Commission should avoid measuring costs in a way that discriminates against rural areas that happen to be served by large carriers. They should also avoid any distribution mechanism that, regardless of actual costs, reduces support based upon the number of local loops served by a carrier. The concept of "intra-company rate averaging," the implicit transfer of revenues between urban and rural areas, cannot survive in a competitive local exchange environment.

If a cost-based system is cost-based and adequately funded, it should meet the statutory requirements that rates for universal service be "just, reasonable and affordable," that urban and rural rates become "reasonably comparable," that contributions for universal service be equitable and nondiscriminatory, and that the universal service mechanism be "sufficient." On the other hand, mechanisms that include size-based criteria will not only fail to meet the statutory tests, but they will improperly deny needed support to high cost rural states. This will impede effective competition by creating two tiers of support for loops with the same underlying costs, and will create perverse incentives for carriers and for state regulators.

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I. Reason for This Filing

The rural states participating in this filing already have filed comments in this proceeding, and they stand by those filings. However, the Joint Board may recommend "bifurcation" of universal service support payments. Since some forms of bifurcation would be very harmful to the commenting rural states, we make this filing.

Rural states have a great deal to lose if the national system for universal service support is poorly designed or inadequately funded. They are pleased that the Telecommunications Act of 1996 requires that the Commission adopt a universal service mechanism capable of ensuring that rates in rural areas are "reasonably comparable" to rates in urban areas. This filing emphasizes that certain kinds of bifurcations would not meet the standards set forth by the 1996 Act.

II. Background on Rural States

Rural states have a strong interest in these proceedings because their demographics impose high costs in providing telephone service. In the coming competitive market for local exchange, rural telephone customers in high cost areas will be at risk of significant rate increases. This makes them particularly interested in ensuring that the universal service mechanisms identified by the Joint Board and the Commission are adequate to protect rural areas under the criteria set forth in the Telecommunications Act of 1996.

The U.S. Census Bureau reports on the proportions of residents in each state who reside in rural areas.¹ The four most rural states in the nation are shown in the following table, in decreasing order of rural dispersion:

¹ A rural area is an area that is not an urban area. An urban area is a place, usually incorporated, that has a population of more than 2,500.

Table 1.
Percentage of Population in Rural Areas - 1990 Census
- Top Four States -

	<u>Percent</u> <u>Rural</u>
Vermont	67.8%
West Virginia	63.9%
Maine	55.4%
Mississippi	52.9%

Whether a state is truly rural is sometimes not immediately apparent. Some states have a low overall population density, but have a population largely concentrated in small areas. This can make such states surprisingly urban. Table 2 shows this pattern for selected western states and Alaska.

Table 2.
Percentage of Population in Rural Areas - 1990 Census
- Selected Western States and Alaska -

	<u>Percent</u> <u>Rural</u>
Nevada	11.7%
Arizona	12.5%
Utah	13.0%
Colorado	17.6%
Texas	19.7%
Alaska	32.5%

It is apparent from Table 2 that many states with low overall population densities nevertheless have populations that are heavily concentrated in settled areas.

"Ruralness," as defined by the Census, appears to be a strong predictor of telephone costs. A state with a high proportion of its population in a rural area will, in general, have a widely dispersed population. This increases average loop length and hence loop costs. Since more switches are required per unit of population, it also can lead to higher switching costs than in urban areas.

The expense of serving rural areas is borne out by universal service data from the National Exchange Carriers Association. Table 3 shows loop costs for regional Bell companies from the same four rural states and the District of Columbia. It also shows the rank among the

same 48 continental Bell operating companies.²

Table 3.
Loop Cost Reported by NECA - 1995
Top Four Rural States and District of Columbia
Cost and Rank Among 48 RBOCs (descending order)

	<u>USF Loop</u> <u>Cost (annual)</u>	<u>Rank</u>
NET Vermont (NYNEX)	\$353.04	3
C&P of West Virginia (Bell Atl.)	322.02	6
NET Maine (NYNEX)	312.18	8
S.C.Bell Mississippi (BellSouth)	352.73	4
U.S. Average	248.43	--
C&P of Wash. D.C. (Bell Atl.)	73.59	48

Among the four rural states, none has a rank higher than 8 among 48 continental Bell operating companies. The one Bell company that serves only urban areas, C&P of Washington D.C., has the lowest loop cost of all 48 companies ranked.

In summary, rural states are not necessarily states with low population densities. As one might expect, rural states have high loop costs and are therefore particularly at risk if mechanisms to preserve universal service should prove to be poorly designed or inadequately funded. Any errors or oversights that might creep into the universal service mechanisms adopted by the Commission could have amplified effects on rural states.

² The areas covered exclude Alaska, Connecticut and Hawaii, but includes the District of Columbia.

III. Cost-Based Support

The universal service distribution mechanism recommended by the Joint Board and adopted by the Commission must be capable of ensuring that rates between rural and urban areas are reasonably comparable.³ To reach this goal, the universal service support system must be based upon the costs that actually influence local rates. Two separate criteria must be satisfied:

- 1) the method of measuring or estimating cost must be accurate and fair; and
- 2) distributions must be based only on measured cost, and other criteria should not be considered. The distribution mechanism should also be equitable and not discriminate on the basis of the receiver.

A. Measuring Cost

The commenting states understand that the Joint Board and the Commission may be considering a "bifurcated" method of measuring cost. The system would use different cost measurement rules for different kinds of carriers. Large carrier costs would be measured by a proxy model; smaller carriers would continue to report costs as in the past.

We urge the Joint Board and Commission to refrain from such an approach. This approach would in essence measure large companies by forward-looking cost and small companies by embedded cost. To the extent that economic costs and book costs may differ, there will be a different standard for measuring costs.

Because of technology enhancements, forward-looking or economic costs tend to be lower than embedded costs. For example, economic or forward-looking pricing calculations generally presume that line concentrators are deployed in optimum locations based upon current costs. However, the cost of subscriber line concentrators and similar technology has dropped significantly in recent years, and this has changed dramatically the balance point at which the newer technology has become feasible. As a result, many incumbent carriers have a significant difference between their embedded and forward-looking costs.

Rural areas are characterized by longer loops. Therefore, the difference between embedded and forward-looking costs can be particularly noticeable in rural areas. If so, a

³ 47 U.S.C. § 254(b)(3).

bifurcated measurement approach could be a serious problem for rural areas that happen to be served by large companies. These areas might have high embedded costs; but the universal service mechanism would not recognize those costs. Under such circumstances universal service support might not permit local rates to be reasonably comparable between urban areas and rural areas that happen to be served by large companies.⁴

Moreover, similar areas that happen to be served by smaller independent companies would see full recognition of their embedded costs, and thus would be entitled to greater support. It is unlikely that such a system could produce rates that are just, reasonable and affordable.⁵

The Joint Board and the Commission should refrain from adopting a system under which some parts of the country use embedded costs to measure universal service support, while other parts of the country are required to use forward-looking costs.

B. Distributing Support

It is not enough to measure costs accurately and consistently. A universal service support system must also distribute support in a manner that satisfied the objectives of the 1996 Act.

The fundamental principle for distribution is that high cost areas must receive the support sufficient to allow for reasonably comparable rates between urban and rural areas. If the Commission were to include non-cost criteria in the support distribution system, the system would be unlikely to meet the statutory goals that rates for universal service be "just, reasonable and affordable," that rates in urban and rural areas must be "reasonably comparable," and that the universal service mechanism be "sufficient." Moreover, the system would be unfair to customers and carriers, and it might create perverse incentives for carriers and regulators.

1. Size-Based Criteria

The Joint Board should recommend abolition of the present system under which carriers who serve more than 200,000 access lines receive reduced support.

A size-based criterion has no valid basis in the Act. Although the Act is detailed on many

⁴ 47 U.S.C. § 254(b)(3).

⁵ 47 U.S.C. §§ 254(b)(1), (i).

matters, it makes no mention of a size-based distribution criterion for universal service.

Further, a size-based criterion has no basis in theory. Although some small companies have very high costs, size by itself is not a reliable predictor of cost. Therefore, if size were adopted, it would be difficult or impossible for the universal service mechanism to achieve the statutory standards.

Consider two geographically distinct but adjacent exchanges in a rural area. Exchange A, owned by Company A, a Bell company, is in a large study area comprising 300,000 lines. Exchange B has identical population distribution, topography and cost characteristics, but is owned by an Company B, a smaller independent company that serves only 100,000 lines. Further suppose that both companies have loop costs equal to 150% of the national average.⁶ Under these facts, current universal service support to Company A in 1997 would be \$0.72 per access line per month, and support for Company B would be \$4.71 per line per month.⁷

To the extent that customers in Exchange A remain loyal to Bell Company A, those customers could expect to pay rates that are \$3.99 per month higher than rates paid by B's customers, not because of underlying costs, but solely because of company size. The rates paid by Bell Company A's customers, being almost \$50 per year higher, cannot be deemed "just, reasonable and affordable."⁸ Moreover, depending on the facts, it is unlikely they could be found "reasonably comparable" to those paid by urban customers.⁹ Further, the universal service support paid to Company A would not be "sufficient"¹⁰ to achieve the other statutory

⁶ The national average loop cost used for the 1997 distributions is \$248.43.

⁷ These hypothetical facts closely approximate the situation of NET-Vermont. Approximately 85 percent of Vermont's access lines are provided by NET-Vermont, which has approximately 311,000 USF loops. Its loop costs are 142 percent of the national average. Because of its size, NET-Vermont is scheduled in 1997 to receive approximately \$2 million in USF support, or about \$0.56 per access line per month. However, if NET-Vermont were divided into two companies for universal service purposes, USF support for 1997 would rise to \$3.65 per access line per month. This difference amounts to \$3.09 per month.

⁸ 47 U.S.C. §§ 254(b)(1), (i).

⁹ 47 U.S.C. § 254(b)(3).

¹⁰ 47 U.S.C. § 254, subsections (b)(5), (d) and (e) require the universal service mechanism to be "specific, predictable, and sufficient."

objectives.

In addition, size-based distinctions create inappropriate incentives, both for carriers and for regulators. Carriers themselves might seek changes to their company service territories solely to increase universal service support. Carriers would discover that certain exchanges would be "worth" more to smaller carriers than to larger carriers, solely as a result of the two-tiered support formula. This could lead to sales of exchanges solely to maximize universal service support.

A size-based distinction in universal service support could also create perverse incentives for regulators. A state commission might, for example, be inclined to divest a large part of its incumbent carrier's service territory, either by simple division of its franchise area or by encouraging the sale of exchanges. No valid public policy would support such actions. We are not aware of any established state or national policy discouraging a local exchange carrier from growing larger than 200,000 access lines.

The Joint Board and the Commission should not establish a universal service mechanism that creates perverse incentives. By means of restrictive rules and continuing vigilance, the Commission could conceivably limit the gains to be made by "gaming" the system. However, even if such vigilance could be effective, it would require a perpetual enforcement program to monitor hundreds or thousands of company and regulatory actions. This unpleasant task can and should be avoided simply by distributing universal service support based solely upon cost.

2. Intra-Company Rate Averaging

Some have argued that a size-based criterion can be included in the universal service mechanism because many states have adopted "averaged" local rate designs for companies wherein high-cost rural customers are subsidized by the company's low-cost urban customers ("intra-company rate averaging").

The Joint Board should explicitly repudiate intra-company rate averaging as a mechanism for supporting universal service.¹¹ First, it is unfair to rural customers because its benefits

¹¹ Although we oppose implicit intra-company rate averaging as a mechanism for universal service fund support, we recognize that the Act requires explicit rate averaging on a national scale. Section 254 requires that sufficient USF funds be collected so that companies may meet their costs with the combination of their revenues from a nationally

cannot be fairly distributed. Not all study areas have equal access to low-cost customers. Even if all carriers are willing and able to engage in price averaging, therefore, some rural areas will still have high rates.¹² On its face, this would seem to violate numerous statutory standards:

- that rates for universal service be just, reasonable and affordable;¹³
- that rates in rural areas be reasonably comparable to rates in urban areas;¹⁴ and
- that the universal service funding mechanism be sufficient.¹⁵

Intra-company rate averaging would also be unfair to urban customers because its burdens cannot be fairly distributed. Urban customers will pay low rates only if they live in a highly urbanized jurisdiction, such as the District of Columbia. Rates will be higher in jurisdictions, like New York and Pennsylvania, where the dominant carrier is burdened with a large rural customer base. Universal service should not be priced higher for urban customers whose carrier happens also to serve large rural areas. Such a situation would violate numerous statutory standards:

- that rates for universal service be just, reasonable and affordable;¹⁶
- that the universal service funding mechanism be sufficient;¹⁷
- that contributions for universal service be equitable and nondiscriminatory¹⁸; and
- that universal service be supported by explicit mechanisms.¹⁹

Intra-company rate averaging is also fundamentally incompatible with a competitive

averaged rate (comparable to urban areas) and their universal service support.

¹² Once again, Vermont is a case in point. Burlington is Vermont's largest city, with an estimated 1994 population of 38,306. This is less than one-quarter the population of Arlington, Virginia. Vermont simply does not have access to a large base of low-cost customers who can provide a subsidy for Vermont's high-cost rural customers.

¹³ 47 U.S.C. §§ 254(b)(1), (i).

¹⁴ 47 U.S.C. § 254(b)(3).

¹⁵ 47 U.S.C. §§ 254(b)(5), (d), (e).

¹⁶ 47 U.S.C. §§ 254(b)(1), (i).

¹⁷ 47 U.S.C. §§ 254(b)(5), (d), (e).

¹⁸ 47 U.S.C. §§ 254(b)(4), (d).

¹⁹ 47 U.S.C. § 254(e).

marketplace.. It presupposes that universal service is provided by a single, vertically integrated monopoly carrier that provides service at uniform rates throughout a large "study area" consisting of that carrier's entire service territory.

The 1996 Act mandates competition in local exchange service. This undercuts all of the premises underlying the existing system. Most fundamentally, competition drives price to cost. This will create pressure on incumbent local exchange carriers to "de-average" their rates, at least by reducing their rates in competitive low-cost areas.²⁰

The system devised by the Joint Board must work in a fundamentally different environment, where implicit transfers cannot survive and where exclusive service territories do not exist.²¹ In the long run, incumbent local exchange carriers will provide service everywhere at rates that are based on local costs, and it will be impossible to sustain implicit subsidies flowing from low-cost areas to high-cost areas. It was for this reason that Congress wisely

²⁰ This geographic de-averaging of basic rates is not only likely for economic reasons, but is also encouraged by Commission rules. Although its action has now been stayed by an appellate court, the Commission recently ruled that rates for interconnection and unbundled elements must be geographically deaveraged into a structure containing at least three zones. *In the Matter of Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, 8/1/96, ¶ 765. If interconnection and unbundling rates are deaveraged by Commission mandate, retail rates will not lag far behind.

²¹ The concept of a large "study area" may become increasingly irrelevant. Incumbent local exchange carriers in all states will soon be competing with new entrants, and many markets will be characterized by multiple overlapping providers.

Some states may certify multiple carriers as "eligible telecommunications carriers" to receive universal service support. 47 U.S.C. § 214(e). In that case the size of the incumbent local exchange carrier cannot fairly be used as the basis to reduce support for the new entrant. As a result, if competitive neutrality is to be maintained, the size of the incumbent cannot be used to reduce support to any carrier, including the incumbent. (Other states, such as West Virginia, suggest that this problem might be solved by certifying only one essential telecommunications carrier in each area.)

Further, incumbent carriers will begin to offer services beyond their own traditional franchise boundaries. Thus a company's economic "footprint" could be much larger or smaller than its traditional study area. Over time, it will become increasingly difficult to operate a universal service support system that is based upon the boundaries of incumbent service territories as they existed in 1996.

concluded that implicit transfers, including intra-company rate averaging, must be replaced by explicit mechanisms.

The net effect on ultimate consumer rates will not be fundamentally different from today. However, two differences will be apparent. Those areas not presently receiving sufficient USF funds to make their rates reasonably comparable to those in the nation's urban areas will experience increased universal service support and consumer rate reductions.²² Also, the implicit transfers that today limit high rates in rural areas will be replaced by explicit transfers mandated by the Commission's rules for universal service support.

IV. Conclusion

Rural states have high loop costs, and thus have the most to lose if the new universal service system is not well designed or is not adequately funded.

The Joint Board should recommend, and the Commission should adopt, a universal service mechanism that is based upon cost. They should avoid any system that would measure cost in some areas based upon historical "embedded" cost, but measure cost in other areas based upon "forward-looking" costs. Such a system could be particularly harmful to rural areas that happen to be served by large carriers.

High cost support should also be distributed based solely upon cost. This means that the Joint Board should repudiate any size-based criterion similar to the existing 200,000 lines distinction. To maintain such a distinction would produce be unfair to rural and urban customers alike, would violate numerous restrictions in the 1996 Act, and would create perverse incentives for carriers and regulators..


It has been possible in the past to assume that intra-company rate averaging could support universal service. The Act's mandate of local competition has eliminated that source of revenue for uniform rates. The Joint Board should not assume that intra-company rate averaging is a viable strategy by which incumbent carriers can support universal service; implicit transfers now supporting universal service must be made explicit.

²² This assumes, of course, that monies provided for universal service funding are sufficient, as required by the Act.


The Joint Board should recommend a universal service system that is suited to the new competitive local exchange environment demanded by the 1996 Act. This must be based upon the costs that drive local rates.

Respectfully submitted,


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Certificate of Service

I, Peter M. Bluhm, hereby certify that on this 24th day of October, 1996, copies of the foregoing comments of:

the State of Maine Public Utilities Commission,
the State of Vermont Department of Public Service,
the State of Vermont Public Service Board, and
the State of West Virginia Public Service Commission

were served by first class mail, postage prepaid, to the parties listed on the attached service list.

Dated: October 24, 1996



Peter M. Bluhm

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